Resurrecting "the Dismal Science" of Political Economy
Could Save Us From Ourselves. But Time Is Short

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Back in the early 1980s an obscure economics professor named Arthur Laffer provided the intellectual ammunition to anti-tax conservatives supporting the argument that a reduction in marginal rates of taxation on income would stimulate investment in the economy while, at the same time, resulting in increased revenue to pay for public goods and services. Not only did federal revenues not increase, but the tax cuts triggered the first stages of income and wealth concentration that threaten the survival of our democracy today. Deregulation of the financial services sector accomplished the rest of what eventually brought on the financial and economic crisis that began in 2008. Was the theory behind supply-side economics flawed? Or, were there externalities that prevented the anticipated outcomes? We are today paying a steep price for the failure of the economics discipline to provide good answers. To the surprise of almost all of those with the most impressive academic credentials, the world was hit in 2008 with a meltdown of the global financial and economic system.

The response by the U.S. government, as recommended by the nation's top economists and financial experts, was the massive corporate bail-out accompanied by a lowering of interest rates (adjusted for inflation) to almost zero. One can argue (and many do argue) that under the circumstances these were measures required to prevent the United States from falling into an abyss and actual systemic collapse. The price paid has been to re-ignite the very forces that brought on the 2008 crisis, forces that have regularly brought on these crises at least once every two decades. If history repeats (and I believe it will), the next meltdown is due by 2026 or 2028. The depth and duration of this next crisis will depend on what measures governments then take in response. I am not optimistic that those charged with developing and implementing public policies have learned much about what causes these cyclical systemic breakdowns. We will need to prepare ourselves for the worst and hope for something less severe.

My reasons for believing as I do are based on forty plus years of combined experience working in the financial sector and teaching political economy to adults. Beginning in the mid-1990s as part of my responsibilities at Fannie Mae (where from 1994 to 2005 I held various management and analyst positions), I prepared periodic updates on the nation's property markets presented at meetings attended by members of the financial sector, government and community organizations. When I retired from Fannie Mae in 2005, I expanded my research and began to annually prepare a report on the state of the U.S. economy and society distributed to subscribers as a public service. This research provided the material for a semester-long course taught in the classroom to adults at the Osher Lifelong Learning Institute at Temple University.

What I had learned and what I was teaching to other adults was based not on the economics I was taught as an undergraduate student back in the late 1960s but on a long study of the writings of the classical era of political economy. What triggered my interest in political economy was a chance attendance at a public forum held in Harrisburg, Pennsylvania to debate the merits of adopting a comprehensive land use plan for the state. This occurred during the summer before my final year of college when I was just beginning to take a serious interest in public policies affecting the environment. A city planner discussed how the imposition of a sufficiently high annual tax imposed on the value of private landholdings could bring down the cost of land, stimulate renewed investment in cities and dampen the emerging pattern of sprawling development. He later sent me a number of articles on the subject, attributing the theoretical arguments to a nineteenth-century political economist named Henry George. I read the articles but paid no further attention to the ideas raised. The year was 1972.

Several years later I was hired to manage the servicing function of the residential mortgage loan program for a commercial bank. Promoted not long thereafter to manage the department, one of my new responsibilities was to represent the bank on a committee focused on revitalization of distressed neighborhoods. I began to read and study articles and papers analyzing the reasons why once-thriving neighborhoods experienced decline. I then remembered that city planner, who had subsequently sent me a large packet of papers and articles to read in support of Henry George's nineteenth-century analysis. Two economists (C. Lowell Harriss at Columbia University and Dick Netzer at NYU) wrote extensively about the destructive impact of how real estate is conventionally taxed. One measure they urged on communities was to adopt the form of property taxation that imposed a much higher rate of taxation on the assessed value of land parcels than on the value of whatever buildings existed on the location. They wrote about Henry George as the political economist responsible for the origin of this policy solution. That eventually sent me off on the study of Henry George's writings, the discovery of an extension in Philadelphia of the Manhattan-based Henry George School of Social Science, and a year-long study of political economy based on the major books written by Henry George.

The world system as explained by Henry George differed considerably from what was contained in the economics texts sitting on my book shelf at home, held onto since my taking the required micro and macro economics courses required for my undergraduate degree in business. What was so different was how George explained that nature (i.e., land) as a factor of production had characteristics quite distinct from that of labor or tangible capital goods. Because of this insight, George proved far more accurate in describing the world in which we actually live than what was being taught in our colleges and universities.

The most serious flaw in the economics taught today is the assertion that price clears all markets, an assertion based on another assertion students are not permitted to question; namely, that there is no basis for treating land as a distinct factor of production. The starting point for useful understanding is to acknowledge that nature (i.e., land) has a zero cost of production in terms of labor and tangible capital goods. Land is the source of what we produce, the source of the tangible goods we rightfully think of and treat as our private property, our wealth. However, as a moral principle, George joined with earlier moral philosophers such as Adam Smith to argue that access to nature is our equal birthright. He studied the ideas of his predecessors and contemporaries to come up with the measures that would guarantee this birthright to all. He found parts of the answer scattered in their writings. He synthesized them into a closed system describing the natural laws governing the production and distribution of wealth. He did this in plain English without having to present his insights using complex mathematical equations and symbols. His book, *Progress and Poverty*, published in 1879, was translated into every major language and sold millions of copies during his lifetime.

Political economy is the study of these laws, which are best described as laws of tendency, affected by the inconsistencies in human behavior and by the systems of law, public policy and taxation in place in any society. What George and other political economists described in their writings was how and why some portion of production was returned to (i.e., claimed by) those who controlled land, those who performed labor, and those who owned capital goods. What Henry George did not know at the time was that the conclusions he reached had been put forward more than century earlier by a school of French political economists known as *Physiocrats*, who argued that access to nature should be allocated to individuals or private entities under conditions of competitive bidding for a leasehold interest; the payment to be made annually they termed a *ground rent*. In the ideal society there would be no deeds issued to establish the private ownership of nature. Adam Smith reached similar conclusions detailed in *The Wealth of Nations* (1776). Then, David Ricardo added a degree of scientific rigor to the arguments by coming up with a *law of rent* describing how land of different potential productivity came to yield different amounts of rent as a portion of the total wealth produced.

What the law of rent explained was the effect of locational advantages, some of which were provided directly by nature, others the result of aggregate investment in public goods and services. Henry George's contributions to the science were threefold. He explained that: (1) the wages of labor and yields to tangible capital goods fell in response to rising rents; (2) the private appropriation of rent and heavy taxation of wages, of yields to capital and of commerce doomed society to cycles of economic boom and bust; and (3) rents were also the highest in centers of high population density and commercial activity. Locations in the central business district of any town or city is valued not by the acre but by the square foot.

When Henry George's book *Progress and Poverty* appeared and he began to lecture in support of his conclusions, people in country after country began to organize to press their governments to adopt the changes he called for in how revenue is raised to pay for public goods and services. His scheme of eliminating all taxation except for that on land rent was soon identified as *The Single Tax*. George and his supporters achieved some partial successes. Cities in Australia and New Zealand exempted all property improvements from their tax base, taxing only the value of land parcels. Johannesburg in South Africa did likewise. For some years, the system was adopted in several Canadian towns and by the province of British Columbia. And, early in the twentieth century, the constitution of the Commonwealth of Pennsylvania was amended to permit the state's large cities to tax land values at a higher rate than buildings, if they chose. This was referred to as local option taxation.

Opponents (referred to by the Physiocrats as *rentier interests*) were quick to recognize the challenge to their opportunity to amass great personal wealth by successfully speculating in land, whether in towns and cities, in fertile agricultural land or land blessed with abundant forests or subsurface minerals. Tariffs on imports were the preferred revenue source. Taxes on income originally designed to reach only those with high incomes were quickly expanded to reach down to those whose only income came from wages. The tax code was amended again and again to reduce the effective rate of taxation on those with incomes not earned as wages but derived from speculations in land, in real estate, in commodities futures and in financial instruments.

What Henry George had tried to effect was an end to the redistribution of wealth that occurred from producers in favor of non-producing *rentier interests*. This was the last best hope for the prevention of the periodic cycles of boom and bust that occurred with regularity every twenty years or so. All other efforts would prove to -- at best -- delay the inevitable or shorten the duration of the economic crisis when it finally occurred.

Trades unions sought the right of collective bargaining to gain higher wages and better working conditions. Socialists called for the nationalization of land, of public utilities and basic industries. As the twentieth century advanced, one systemic crisis after another erupted. The financial crisis of 1905 eventually led to the establishment of the Federal Reserve System in the United States. Local and state governments in need of revenue began to introduce new forms of taxation on every sort of tangible asset, on commerce and on services. The elected officials who voted for or against these forms of taxation seldom concerned themselves with actual economic principles. If that were the case, our state and local governments would not attempt to raise revenue by the taxation of every income-producing activity and every form of asset. Economists have come to describe the effect of most forms of taxation as imposing heavy *dead weight losses* on economic output. There is one exception and one exception only: the taxation of land rent.

Getting from where we are today to where optimally we ought to be is, to be frank, a practical impossibility. Real estate is taxed most directly by local governments – by municipalities, by boroughs, by townships, by counties – and by school districts. State constitutional amendments would be required just to give these taxing jurisdictions the local option to move to a land value only tax base. Proponents have been trying to achieve these changes since the beginning of the twentieth century with few successes to point to. Even when implemented, those who profit most by property speculation seem to have the last say on legislation. Financial contributions to candidates for elected office pay dividends to the *rentier* property interests.

There is a back door approach that while not perfect has the merit of broad application. If our federal government and state governments are to continue to raise a portion of revenue from the taxation of individual income, proponents could campaign for reforms that combine simplicity of compliance with real progressivity that captures unearned income. The approach I believe to be both economically efficient and equitable is for government to exempt all individual incomes up to some amount (e.g., the national, or where applicable, the state median income). Eliminate all other exemptions and deductions. Incomes from all sources would be reported and subject to the same schedule of tax rates. For ranges of income above the exempted amount, a gradually-increasing rate of taxation would be applied, the rates and ranges determined during the budgeting process to meet the revenue needs of government. This simplified but graduated tax structure could also be adopted by municipal governments that today apply a flat rate of taxation to wages and salaries. No doubt some earned income would be taxed, but those required to pay the tax would have the ability to pay.

As noted above, all (or almost all) local governments rely on property taxation to raise a portion of needed revenue. Historically, school districts have imposed the highest rates of taxation on real estate. However, issues of equity as well as adequacy of property as a revenue base are increasingly a subject of public frustration. The arguments against reliance on revenue from property taxation to fund our public schools are valid. Districts with high property values are able to generate significant revenue with a relatively low rate of taxation, whereas economically distressed districts must receive state and federal support in order to provide comparable levels of educational opportunity to children.

Absent from the debates over how to fund the public school systems is the real impact of property taxation on local and regional economies. There is an optimum amount of revenue that should be raised from property taxation regardless of what the revenue is used for. This optimum revenue equals the aggregate land rent of every privately-held parcel of land within the taxing jurisdiction. Above this aggregate land value the tax is confiscatory and acts as a disincentive to job-creating investment; less than this amount leaves to land owners an imputed (or, when land parcels are leased to tenant users, an actual) rental income stream that is 100% unearned and results in the holding of land off the market for speculative gain. Land values are generated by aggregate demand and are directly related to public investment in infrastructure and amenities. The taxation of property improvement values is, on the other hand, inherently confiscatory and counter-productive. Buildings are depreciating assets that require continuous expenditures for maintenance and periodic replacement of essential systems. Owner of buildings are penalized for maintaining or improving their buildings by what equates to a sales tax on the assessed value of their buildings imposed year after year after year.

A related issue is the matter of property assessment, which is almost everywhere influenced by local political pressures and rarely maintained at a uniform percentage of market values. Ideally, if property improvements were exempted from the tax base, the annual tax on land values should be equal to what the land parcel would yield under lease (i.e., its rental value). Even with the existing system the only solution to assessment inequities is to turn the responsibility over to a state agency run by assessment professionals who meet strict professional credentials.

While any shift away from the taxation of the goods or assets we produce and the services we provide one another is sound policy, a comprehensive reform of how government raises its revenue is desperately needed. The measures I have outlined above are neither conservative nor liberal in design; they transcend political orthodoxy and offer a reality-based set of policies that would significantly reduce the impact of what is coming, namely modern history's most destructive financial and economic crisis. This is the most important lesson to be learned from the dismal science of political economy.